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SUBJECT: GOC PREPARES TO PRIVATIZE SHIPYARDS

¶1. (U) SUMMARY: The GOC has begun the process to privatize shipbuilding, the last major industry under state ownership in Croatia. Subsidies to the loss-making industry have been a burden on the state budget and are an obstacle to EU accession. The Ministry of Economy and representatives of the shipyards reached agreement on October 11 and 13 on the main terms for privatization, and the GOC has submitted the proposed tenders to the EU for review. Regardless of the terms, it is uncertain whether the government will attract any investors in the current less-than-favorable economic climate. Aware of this possibility, the EU has asked for a contingency plan, which the GOC will likely not complete this year. These remaining challenges may complicate Croatia's ability to stay on course for completing its EU accession negotiations in 2009. End Summary.

¶2. (U) Over the past six months, the GOC has begun to move toward privatizing Croatia's politically sensitive shipbuilding industry. Although the government has been reluctant to begin the process, it now has no choice since state subsidies to shipyards is one of the two major problem areas identified by the EU as obstacles to fully opening accession negotiations. The loss-making shipyards burden the state budget annually with about $80-100 million in subsidies and about $450 million in loan guarantees. Olgica Spevec, president of the Council of the Croatian Competition Agency, told us that the reasons for the privatization moves go beyond state budgetary concerns to a basic understanding that the industry would be more successful under private ownership, in the hands of investors who know the global market well and can find the right niches for profitability. She said the original restructuring plans submitted to the EU in June were developed largely by the current management of the shipyards and proposed restructuring while maintaining state ownership. The GOC, however, had already begun planning for privatization and, through consultations with the EU, decided to scrap the submitted plans and prepare privatization models for all the shipyards.

¶3. (U) Several factors have made privatization politically difficult. Croatia has a long tradition of shipbuilding and the fear of large-scale job losses has caused anger in Croatia's port cities. The GOC has tried to address these concerns in the proposed privatization plans and seems to have gained at least tacit approval from the unions to move forward.

¶4. (SBU) Work by the World Bank, however, suggests the real effects of privatization on workers and local economies may be different from the widely held expectations. The Bank's findings indicate that workers are not as dependent on the shipyards as presumed, since some 80 percent have secondary jobs or experience in other fields. Further, shipyard communities may not be as dependent on the industry as presumed, since most workers commute more than half an hour to the yards. The Bank also found workers more willing than management to make whatever changes were needed to improve enterprise viability. Noting that privatizing the shipyards has thus far been "taboo to an unbelievable extent," Sanja

Madzarevic-Sujster, senior country economist at the Bank's Croatia office, suggested the status quo may provide significant graft opportunities to managers, who, she observed, are "running loss-making enterprises but driving the latest model BMWs."

¶5. (U) The Ministry of Economy and representatives of the shipyards reached agreement on October 11 and 13 on the main terms for privatization. Deputy PM and Minister of Economy Damir Polancec then presented the tender proposals to the EU in Brussels. Assuming EU approval, the ministry plans to post the tenders in November. According to press reports, four of the shipyards--3 May, Kraljevic, Brodotrogir, and Brodosplit--will be offered for a starting price of 1 HRK ($0.20) in a public tender process. Potential buyers will be asked to specify how much of the shipyard's credit liabilities they will assume. They also will be required to recapitalize the enterprise within one year, continue shipbuilding activities, and respect existing collective work agreements until expiry. Workers at each shipyard will be offered 25 percent stock plus 1 share at discounted rates. According to a separate agreement for Uljanik, the best performing (though still not profitable) of the yards, the GOC will issue a tender for a 25 percent stake in the enterprise. Then, as with the other shipyards, workers will be offered 25 percent stock plus 1 share at discounted rates. In the final phase, 33 percent of the enterprise will be offered to investors, with a cap of 2-3 percent of shares per investor. Some press reports indicate the proposals include continued state subsidies and plans for the state to assume some of the shipyards' debt. A Ministry of Economy contact who has worked on the proposals says the press information has been mostly accurate, though he declined to confirm any

details for us while they are still in negotiation with the EU.

¶6. (SBU) The privatization plan is meeting with skepticism. The EU is still reviewing the proposed tenders, but local papers are already reporting EU disapproval of some of the terms, such as the continuation of state subsidies, the state's assumption of part of the shipyards' debt, and the prohibition of converting the enterprises to another industry. Charlotte Ruhe, director of the European Bank for Reconstruction and Development in Croatia, told us she doubts the GOC will find many interested bidders under the proposed terms and given the current global economic situation. Spevec commented that the government may have missed its best chance earlier this year, when ship orders were strong and several investors were expressing interest. The shipyards reportedly have already begun losing orders due to the global financial crisis, and some analysts have called for the government to delay posting the tenders, while others have suggested the GOC would better spend its efforts preparing bankruptcy plans than privatization plans for most of the shipyards. In September, Josko Klisovic, secretary of the MFA's EU Accession Negotiating Group, told us the EU has asked for a contingency plan in case the sale of the shipyards does not succeed. He seriously doubted the government could prepare a backup plan in addition to the main privatization plan by the end of this year.

¶7. (U) COMMENT: Although the GOC finally appears serious about privatizing shipbuilding, the challenges are formidable. The Ministry of Economy is hoping for some leniency from the EU in acknowledgment of Croatia's shipbuilding tradition, but this hope is likely in vain, given the difficult decisions other shipbuilding countries, such as Germany, the UK, and Poland, have had to make as part of the EU. In any case, EU approval of the plans is only a preliminary step to the real task of attracting investors. Although PM Sanader remains publicly optimistic about opening all negotiating chapters this year in order to complete accession negotiations in 2009, the hurdles remaining for shipyard privatization loom as the most likely reason that

this schedule could slip. END COMMENT.
Bradtke